KENSINGTON ENERGY LTD.

Annual Report 1996

Corporate Profile

Kensington Energy Ltd. is an exploration-based, junior oil and gas company with operations concentrated in central & northwest Alberta. Since raising $7,000,000 from its initial public offering in August, 1995, we have focused our efforts on exploratory drilling for new oil and gas pools. Successful execution of our strategy has increased Kensington's production from nil in August, 1995 to over 400 boe/d currently. The Company's Class A shares, Class B shares and Warrants trade on The Alberta Stock Exchange under the trading symbols KNN.A, KNN.B and KNN.WT.A respectively.

Annual Meeting

The Annual and Special Meeting of Shareholders will be held at 3:00 p.m. on May 21, 1997 in the Lake Louise Room of the Westin Hotel located at 320 Fourth Avenue SW, Calgary, Alberta.

Shareholders are encouraged to attend and those unable to do so are requested to complete and return the proxy form at their earliest convenience.

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Abbreviations

bbls	barrels
bbl/d	barrels per day
boe	barrels of oil equivalent (1)
boe/d	barrels of oil equivalent per day
mbbl	thousand barrels
mcf	thousand cubic feet
mcf/d	thousand cubic feet per day
mmcf	million cubic feet
mmcf/d	million cubic feet per day
NGLs	natural gas liquids

(1) 1 boe = 10,000 cubic feet or 10 mcf

Nineteen Ninety Six Highlights

Financial	1996	1995
Petroleum and Natural Gas Sales [1]	$ 748,590	$ –
Funds from Operations [1]	$ 483,094	$ –
Per Class A Share (Basic)	$ 0.13	$ –
Per Class A Share (Fully Diluted)	$ 0.06	$ –
Net Income [1]	$ 129,178	$ –
Per Class A Share (Basic)	$ 0.04	$ –
Per Class A Share (Fully Diluted)	$ 0.02	$ –
Working Capital	$ 1,173,844	$ 4,813,928
Capital Expenditures	$ 5,265,184	$ 1,648,973
Class A Shares Outstanding		
Weighted average	3,579,062	3,570,000
Year End	3,790,500	3,570,000
Closing Price	$ 2.01	$ 1.05

Operating	1996	1995
Production [1]		
Oil & NGL's (bbl/d)	131	–
Natural Gas (mcf/d)	122	–
Barrels of Oil Equivalent (boe/d) - average	143	–
- December	189	–
Reserves (Proven plus Probable)		
Oil & NGL's (bbls)	702,000	11,810
Natural Gas (mmcf)	2,815	–
Undeveloped Land		
Gross Acres	42,105	18,895
Net Acres	15,095	5,941
Drilling Activities		
Gross Wells	27.0	11.0
Net Wells	8.7	2.6

[1] For the 6 months ended December 31, 1996.

Message to the Shareholders

In August 1995, Kensington became a public company with virtually no oil and gas assets but with a clear and focused vision on how to build value for our shareholders.

We believe that drilling a portfolio of well conceived, technically strong exploration prospects will lead to meaningful new pool discoveries of oil and gas and provide the most sustainable way for Kensington to grow and produce above average returns to our shareholders.

In our view, good drilling prospects are the scarce commodity in our business. As a result, we devote a significant amount of time and energy to developing these good drilling ideas and then testing those ideas with the drill bit. We constantly strive to keep focused on this goal in order to build a solid reserve base and grow the Company's production.

Oil and gas companies make significant capital investments on behalf of their shareholders and must earn a sufficient rate of return on that investment over a reasonable time frame. This means that management must have a disciplined economic approach to determine where to invest a company's drilling dollars. Not all reservoirs are created equal and neither is every BOE of production.

Our strategy of drilling good exploration prospects and applying sound economic criteria led to the following accomplishments in 1996:

- 3 new pool discoveries (2 on internally-generated ideas) with excellent reservoir characteristics
- added almost 1 million boe of reserves (proven and probable) at a total finding and onstream cost of $5.24 per boe
- reached commercial production beginning July 1, 1996 with production averaging 144 boe/d for the 6 months ended December 31, 1996, 189 boe/d in December and current production of over 400 boe/d
- achieved field netbacks of $21.12 per boe
- achieved a reinvestment ratio (field netback: onstream costs) of 4:1, an indication of the high rate of return the Company generates on its capital investments
- generated $483,094 of cash flow and $129,178 of net income for the 6 months ended December 31, 1996 or $0.13 and $0.04 per class A share, respectively
- ended the year with a net asset value of $2.39 per Class A share.

Outlook

Kensington has a tremendous number of opportunities available in the year ahead and we believe the coming year will be one of continued growth for the Company. We base our enthusiasm on the following factors:

- a solid prospect inventory with land acquired on many of these prospects

- a drilling rig contracted for 2 years, a distinguishing asset among junior companies in the current environment

- a $6 million capital budget for 1997 to exploit the Company's drilling opportunities.

Kensington continues to build its technically-strong prospect inventory and expects to drill 20 to 25 wells in 1997 with approximately half of these wells being exploration wells. The Company will continue to be active in its core areas of central and northwest Alberta, with some activity planned outside of our recent areas of activity. Our average working interest will increase from the 32% interest in 1996 and the Company will endeavor to operate a significant portion of its wells in 1997.

In order to maintain a high level of drilling activity in light of very high demand for contract drilling services, Kensington has contracted to utilize 60% of a drilling rig for 2 years. Access to this drilling rig will allow the Company to maintain its growth rate and provide some drilling cost predictability.

In order to capitalize on the opportunities in front of us, we have established an initial 1997 capital budget of $6 million which will be financed from existing working capital, cash flow, exercise of outstanding warrants and bank debt.

We wish to acknowledge the skills and dedication of our staff and directors who have played a large role in Kensington's success. We would also like to thank our shareholders for their support.

On behalf of the Management and the Board

Kevin McLachlan

Kevin McLachlan
President
April 1, 1997

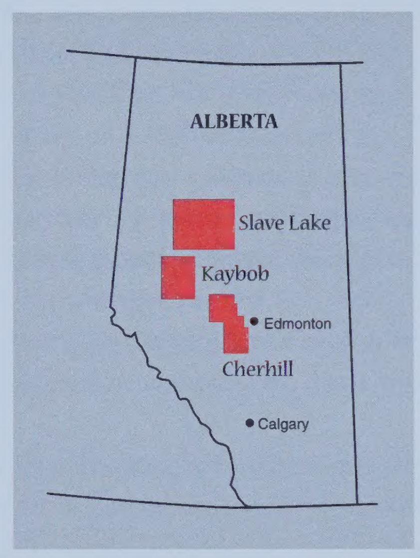
Exploration and Operations

Kensington participated in an active drilling program in 1996 with the drilling of 27 wells (8.7 net wells). The Company generally had access to a drilling rig throughout the year so that its drilling plans were not significantly affected by lack of rig availability. To maintain its active drilling program, the Company has contracted to utilize 60% of a drilling rig from May, 1997 to May, 1999.

The highlights of Kensington's exploration activities during 1996 were 3 new pool discoveries, 2 of which were the result of internally-generated ideas:

- a light oil (38 API°) discovery at Giroux Lake in June (40% working interest)
- a liquids-rich natural gas discovery at Ferrybank in September (17.8% working interest)
- a liquids-rich natural gas discovery at Cherhill in October (40% working interest)

Production from these discoveries has increased the Company's production from 29 bbl/d in June to over 400 boe/d currently.

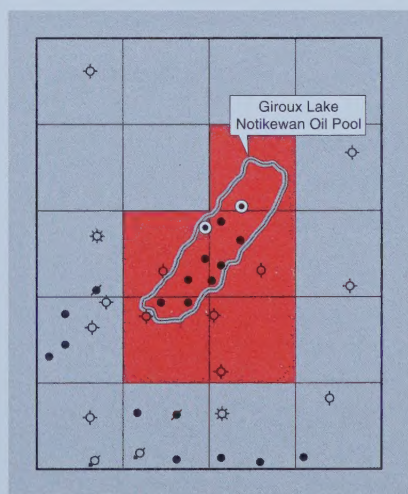


Kensington Exploration Areas

Kaybob Area

Giroux Lake

Since the discovery well was drilled on this prospect in June, 1996, a total of 8 oil wells have been drilled into this pool which produces 38° API oil from the Notikewan sand. Kensington has an average 40% working interest in the pool. Production from the pool is currently restricted by the Alberta Energy and Utilities Board pending implementation of a waterflood. Once the waterflood is implemented later this year, it is anticipated that pool production will increase from approximately 385 bbl/d (155 bbl/d net) to 575 bbl/d (230 bbl/d net). The waterflood will also increase the recoverable reserves from the pool. In addition, we believe the pool may extend further to the north and plan to drill 2 to 3 more wells here later this year. Success with these wells will further increase production and recoverable reserves.



⦿ 1997 Locations

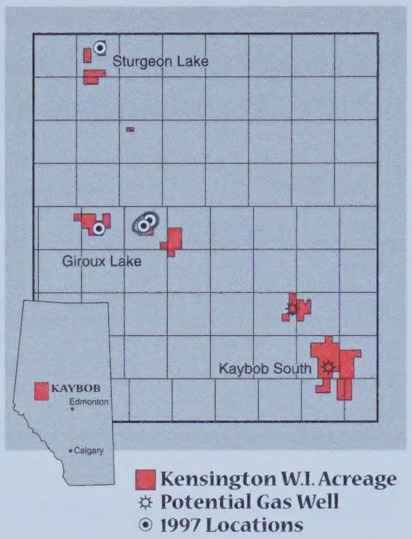
The Giroux Lake area has a number of excellent prospective hydrocarbon producing zones. Kensington has developed several exploration prospects in this area and has assembled a large land base on these prospects. The Company has working interests ranging from 25% to 50% in 18 sections (11,520 acres) and an option on a further 8 sections (5,120 acres) of land in this area. One exploration well is planned immediately after spring break-up.

Sturgeon Lake

Kensington has working interests ranging from 40% to 100% in 11.5 sections (6,080 acres) in the Sturgeon Lake area. Two exploration wells are planned for this area after spring break-up.

Kaybob South

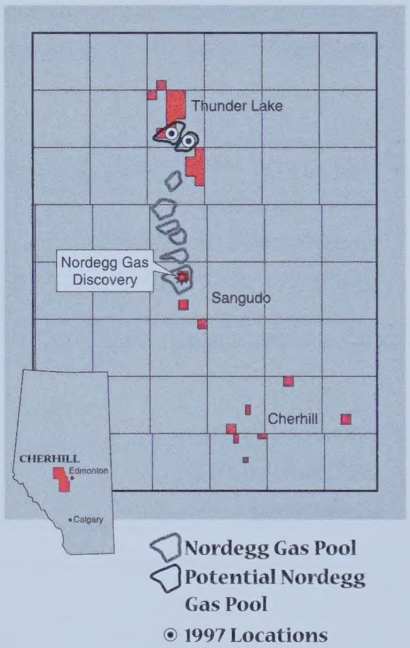
The Company has earned a 25% before payout working interest in 2 sections, (15% after payout) and a 15% working interest in 10 sections of land (total of 12 sections or 7,680 acres) with the drilling of 3 wells in this multi-zone oil & gas prospect area. The Company is testing 2 wells and has the option to earn additional acreage with the drilling of further wells.



CHERHILL AREA

Sangudo

In October, Kensington drilled a new pool, liquids-rich natural gas discovery at Sangudo. The Company has a 40% working interest in the discovery well which produces natural gas, condensate and NGLs from the Nordegg sand. The well currently produces at a restricted rate of approximately 3 mmcf/d (1.2 mmcf/d net) of sales gas and 90 bbl/d of NGLs (36 bbl/d net). Kensington has a 40% working interest in an additional 2 sections (1,280 acres) along this exploratory trend. New seismic data has recently been acquired to evaluate further drilling locations.



Thunder Lake

Kensington has a 40% working interest in 6 sections (3,840 acres), a 30% working interest in 9 sections (5,760 acres) and a 20% working interest in 3 sections (1,280 acres) of land at Thunder Lake. One exploration well is planned in the near future to test a Nordegg gas prospect.

The Cherhill area, like the Kaybob area, is an excellent multizone area for hydrocarbon prospects, and Kensington has developed prospects targeting oil and gas in a number of different zones in addition to Nordegg prospects.

SLAVE LAKE AREA

Kensington has a 50% working interest in 5 sections (3,200 acres) of land on a shallow natural gas prospect in this area and plans to drill one exploration well shortly.

The Company also has a 33% working interest in 2 light oil prospects and a 25% working interest in a third light oil prospect in this area. At least 2 exploration wells will be drilled on these prospects next winter.

Reserves and Present Value

The table below summarizes the results of an independent engineering evaluation of the Company's reserves prepared by Brusset Consultants as of January 1, 1997.

				Present Value ($000s) before Income Taxes Discounted at			
Reserves (before Royalties)	Oil (mbbl)	NGLs (mbbl)	Pipeline Gas (mmcf)	0%	10%	15%	20%
Proven	339	44	1,681	7,141	5,826	5,342	4,935
Probable	289	30	1,134	6,710	4,496	3,789	3,247
Total	628	74	2,815	13,851	10,322	9,131	8,182

Finding and Onstream Costs

	Total	**1996**	1995
Finding and Development Costs			
Land Acquisition	$ 1,048,296	**$ 714,799**	$ 333,497
Seismic and Geological	876,422	**422,684**	453,738
Drilling and Completion	3,986,704	**3,385,613**	601,091
Capitalized General and Administrative	654,822	**459,823**	194,999
	6,566,244	**4,982,919**	1,583,325
Onstream Costs			
Well Equipping	72,221	**51,008**	21,213
Gathering	223,739	**209,140**	14,599
	295,960	**260,148**	35,812
	$ 6,862,204	**$ 5,243,067**	$ 1,619,137
Total Reserve Additions (boes)	1,013,191	**999,995**	13,196
Finding and Development Costs (per boe)	$ 6.48	**$ 4.98**	
Onstream Costs (per boe)	0.29	**0.26**	
Total Findings & Onstream Costs (per boe)	$ 6.77	**$ 5.24**	

Drilling Activity

During the year, Kensington participated in the drilling of 27 gross (8.7 net) wells. Of these wells, 16 were exploration wells and 11 were development wells. The table below summarizes the Company's drilling activity.

	Exploration		Development		Total	
	Gross	Net	Gross	Net	Gross	Net
Oil	1.0	0.40	8.0	2.53	9.0	2.93
Gas	4.0	1.38	–	–	4.0	1.38
D&A	11.0	3.20	3.0	1.20	14.0	4.40
Total	16.0	4.98	11.0	3.73	27.0	8.71

Undeveloped Land

Kensington's undeveloped land position increased by 123 percent, from 18,895 gross acres at the beginning of the year, to 42,105 at the end of the year. On a net undeveloped basis, our position increased by 154 percent from 5,941 acres to 15,095 acres.

Undeveloped Land	**1996**	1995
Gross Acres [1]	**42,105**	18,895
Net Acres [2]	**15,095**	5,941
Average Working Interest (%)	**35.9**	31.4

[1] "Gross acres" means the area of land in which Kensington has a working interest.

[2] "Net acres" means the sum of the products obtained by multiplying the number of gross acres by Kensington's percentage working interest therein.

Management's Discussion & Analysis

Financial Results 1996 - Effective July 1, 1996, Kensington attained commercial production and, accordingly, net income and funds from operations are for the 6 months ended December 31, 1996. The financial highlight for the year was the transition that the Company made from being in the preproduction stage to an operating company, generating $483,094 of cash flow ($0.13 per Class A share, $0.06 fully-diluted) and net income of $129,178 ($0.04 per Class A share, $0.02 fully-diluted).

Revenue

Production at commercial levels commenced July 1, 1996. Revenues from petroleum and natural gas sales for the 6 months ended December 31, 1996 were $748,590. Commercial production of crude oil commenced in July while production of natural gas, condensate and NGLs commenced in November. Revenue from the various products is shown in the table below.

		Revenue	
Product	BOE Production	Total	Per BOE
Oil and Condensate	23,570	$ 680,945	$ 28.89
Natural Gas	2,245	47,070	20.97
NGLs	607	20,575	33.90
Total	26,422	$ 748,590	$ 28.33

Production during the period averaged 144 boe/d and 189 boe/d in December. Current production is over 400 boe/d as a result of further natural gas and NGL production coming onstream late in 1996.

Royalties and ARTC

Royalties to the Crown, freehold owners and third parties for the 6 months ended December 31, 1996 were $156,395 ($5.92 per boe) of which $72,501 ($2.74 per boe) was recovered under the Alberta Royalty Tax Credit (ARTC) program.

Interest Income

As a result of the Company's initial public offering in August, 1995, cash was invested in short-term, interest bearing, low risk investments with maturity dates coordinated with capital expenditure requirements. These investments earned interest of $28,606 for the 6 months ended December 31, 1996.

Production Expenses

Production expenses were $106,532 ($4.03 per boe) for the 6 months ended December 31, 1996.

General and Administrative

General and administrative expenditures are shown in the table below:

General and Administrative		**1996**		1995
Total General and Administrative Expenditures	$	**563,499**	$	194,999
Less Capitalized as Part of Petroleum and Natural Gas Properties:				
During Preproduction Stage		**(285,155)**		(194,999)
July 1 to December 31		**(174,668)**		–
	$	**103,676**	$	–
Per Boe	$	**3.92**	$	–

Total general and administrative costs increased by 189 percent in 1996 over 1995. 1996 general and administrative costs were for a full year, whereas 1995 general and administrative costs were for 5 months only. Total general and administrative expenditures are anticipated to be higher in 1997, although such expenditures should be lower per boe since production has increased significantly since 1996.

Depletion, Depreciation and Amortization

Total depletion, depreciation and amortization (DD&A) expense for the 6 months ended December 31, 1996 was $151,916 ($5.75 per boe). Included in the total DD &A expense was depletion expense of $144,998 ($5.49 per boe), which amounts to a depletion rate of 3.96%.

Deferred Income Taxes

The Company's deferred income tax provision for the 6 months ended December 31, 1996 was $202,000 ($7.65 per boe). The deferred income tax provision was 61% compared to a statutory corporate income tax rate of 44.62% because of the renunciation of corporate tax pools to investors through the issue of flow-through shares. While this rate is high, it should be reduced in future years as the Company keeps its tax pools generated by continuing capital expenditures.

Boe Analysis

Production volume for the 6 months ended December 31, 1996 was 26,422 boe. The following table analyzes field netbacks, funds from operations and net income on a boe basis.

		Per Boe
Revenue	$	28.33
Royalties		(5.92)
ARTC		2.74
Production Expenses		(4.03)
Field Netback		21.12
Interest Income		1.08
G&A		(3.92)
Funds from Operations		18.28
DD&A		(5.75)
Deferred Income Tax		(7.65)
Net Income		4.88

Capital Expenditures

Capital expenditures for 1996 were $5,265,184, an increase of 219 percent over the $1,648,973 reported in 1995. The increase resulted from the Company being active for the entire year in 1996 and discoveries in 1996 which necessitated increased capital spending on development drilling, completion, well equipping and gathering.

The following table provides a comparative analysis of capital expenditures for 1996 and 1995.

	1996	1995
Land Acquisition	$ 714,799	$ 333,497
Seismic and Geological	422,684	453,738
Drilling and Completion	3,385,613	601,091
Capitalized G & A	459,823	194,999
Well Equipping and Gathering	260,148	35,812
Furniture and Equipment	22,117	29,836
	$ 5,265,184	$ 1,648,973

Our 1997 capital program is currently established at $6,000,000, a 14% increase over 1996.

Net Asset Value

Assets	December 31, 1996	Assuming IPO Warrants Exercised
Reserves (proven plus half probable @ 15%)	$ 7,236,500	$ 7,236,500
Undeveloped Land (1)	1,238,027	1,238,027
Working Capital	1,173,844	1,173,844
Proprietary Seismic	151,580	151,580
Warrant Exercise Proceeds (2)		1,890,000
Total Assets	$ 9,799,951	$ 11,689,951
Liabilities		
Site Restoration and Abandonment	(3,154)	(3,154)
Net Asset Value	$ 9,796,797	$ 11,686,797
Class A Shares Outstanding (3)	4,098,500	5,358,500
NAV Per Class A Share	$ 2.39	$ 2.18

(1) Value of 1996 land purchases at cost, value of 1995 land purchases at 80% of cost.

(2) Assumes exercise of 1,260,000 warrants at $1.50 each.

(3) Also includes 308,000 Class A shares to be issued upon exercise of flow-through exchange rights, but not outstanding at year end.

AUDITORS' REPORT

To the Shareholders of Kensington Energy Ltd.

We have audited the balance sheets of Kensington Energy Ltd. as at December 31, 1996 and 1995 and the statement of income and retained earnings for the six month period ended December 31, 1996 and statements of cash flow for the year ended December 31, 1996 and for the period from incorporation on January 25, 1995 to December 31, 1995. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1996 and 1995 and the results of its operations for the six month period ended December 31, 1996 and the changes in its financial position for the year ended December 31, 1996 and for the period from incorporation on January 25, 1995 to December 31, 1995 in accordance with generally accepted accounting principles.

Ernst & Young

Chartered Accountants

Calgary, Alberta
March 11, 1997

BALANCE SHEETS

As at December 31	1996	1995
Assets		
Current		
Cash and Short Term Deposits	$ 1,732,924	$ 1,934,489
Accounts Receivable	493,574	456,742
Subscriptions Receivable (note 4)	–	2,947,000
	2,226,498	5,338,231
Property and Equipment (note 3)	4,197,949	1,018,487
Accumulated Depletion and Depreciation	(148,762)	–
	4,049,187	1,018,487
Deferred Income Taxes (notes 4 and 5)	150,167	328,724
	$ 6,425,852	$ 6,685,442
Liabilities and Shareholders' Equity		
Current		
Accounts Payable	$ 1,052,654	$ 524,303
Site Restoration and Abandonment Provision	3,154	–
Shareholders' Equity		
Share Capital (note 4)	5,240,866	6,161,139
Retained Earnings	129,178	–
	5,370,044	6,161,139
Commitment (note 7)		
	$ 6,425,852	$ 6,685,442

See Accompanying Notes.

Approved by the Board:

Kevin McLachlan

Kevin McLachlan
Director

Ronald Quillian
Director

STATEMENT OF INCOME AND RETAINED EARNINGS

For the Six Month Period Ended December 31		1996
Revenue		
Petroleum and Natural Gas Sales	$	748,590
Royalties		(156,395)
Alberta Royalty Tax Credit		72,501
Interest Income		28,606
		693,302
Expenses		
Production		106,532
General and Administrative (note 3)		103,676
Depletion, Depreciation and Amortization		151,916
		362,124
Income Before Income Taxes		331,178
Deferred Income Tax Provision (note 5)		202,000
Net Income for the Period		129,178
Retained Earnings, Beginning of Period		–
Retained Earnings, End of Period	$	129,178

Earnings Per Class A Share (note 6)

See Accompanying Notes.

STATEMENTS OF CASH FLOW

	For the Year Ended December 31, 1996	From January 25, 1995 to December 31, 1995
Operating Activities		
Net Income	$ 129,178	$ –
Add Non-Cash Items		
Depletion, Depreciation and Amortization	151,916	–
Deferred Income Taxes	202,000	–
Funds from Operations	483,094	–
Changes in Non-Cash Working Capital Items	21,334	–
	504,428	–
Financing Activities		
Issue of Class A Shares	496,125	714,000
Issue of Flow-Through Exchange Rights	699,160	–
Issue of Class B Shares	2,947,000	3,549,000
Deferred Income Taxes	(23,443)	(328,724)
Share Issue Costs	(29,836)	(418,375)
	4,089,006	3,515,901
Investing Activities		
Expenditures on Property and Equipment	(5,265,184)	(1,648,973)
Changes in Non-Cash Working Capital Items	470,185	67,561
	(4,794,999)	(1,581,412)
(Decrease) Increase in Cash and Short Term Deposits	(201,565)	1,934,489
Cash and Short Term Deposits, Beginning of Period	1,934,489	–
Cash and Short Term Deposits, End of Period	$ 1,732,924	$ 1,934,489

Funds from Operations Per Class A Share (note 6)

See Accompanying Notes.

NOTES TO FINANCIAL STATEMENTS

December 31, 1996

1. Incorporation and Commencement of Operations

The Company was incorporated under the laws of the Province of Alberta by Articles of Incorporation dated January 25, 1995 with an initial share capital of one Class A common share for cash consideration of $0.20. The Company's business is the acquisition of petroleum and natural gas rights and the exploration for, development and production of, crude oil and natural gas. All activity is conducted in the Province of Alberta.

The Company was in the preproduction stage from January 25, 1995 to June 30, 1996 and during this period, all costs net of revenues were deferred. Effective July 1, 1996 production at commercial levels was attained and all of the deferred exploration costs were transferred to the Company's full cost pool. Accordingly, the statement of income and retained earnings reflects the Company's operations for the six month period ended December 31, 1996.

2. Summary of Significant Accounting Policies

Property and equipment

Capitalized costs

The Company follows the full cost method of accounting whereby all costs related to the exploration for and the development of petroleum and natural gas reserves are initially capitalized.

Capitalized costs include lease acquisition, geological and geophysical expenditures, lease rentals on non-producing properties, costs of drilling both productive and non-productive wells, equipment costs and that portion of general and administrative expenses applicable to these activities.

Proceeds from disposal of properties will normally be applied as a reduction of the cost of the remaining assets unless the disposal results in a change in the depletion rate of greater than 20%, in which case a gain or loss on disposal will be recorded.

Depletion and depreciation

Depletion of petroleum and natural gas properties and depreciation of production equipment is provided for using the unit of production method based on estimated proved petroleum and natural gas reserves, as determined by independent engineers.

The depletion and depreciation cost base includes total capitalized costs, less costs of unproved properties, plus provision for future development costs of proved undeveloped reserves, as determined by independent engineers. Costs incurred for facilities under construction at year end are excluded from the cost base.

The relative volumes of oil and gas reserves and production are converted at a ratio of ten thousand cubic feet of gas to one barrel of oil.

Computer equipment and furniture is carried at cost and are depreciated over the estimated useful lives of the assets at rates of 20% to 30% calculated on a declining basis.

Site restoration and abandonment

Estimated future site restoration and abandonment costs are accrued on the unit of production method. Estimates are based on costs and regulations in effect at year end. The annual charge is included in depletion expense.

Ceiling test

The Company applies an annual ceiling test to capitalized costs, net of deferred income taxes and the site restoration provision, to ensure that the net carrying value does not exceed the estimated value of future net revenues from production of proved reserves less future production related general and administrative expenses, financing costs, estimated future site restoration and abandonment costs and income taxes, plus the lower of cost and estimated fair market value of unproved properties. Any reduction in value, as a result of the ceiling test, will be charged to operations.

The calculation of future net revenues is based wellhead prices and costs, and the income tax and Alberta royalty tax credit legislation in effect at year end.

Flow-through shares

The Company has financed the majority of its exploration and development activities through the issue of flow-through shares. Under the terms of the flow-through share issues, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregone tax benefits to the Company, the carrying value of the properties acquired and the shares issued are recorded net of the tax benefits renounced to subscribers when the expenditures are incurred.

Joint operations

Substantially all of the Company's exploration and development activities are conducted jointly with others and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

3. Property and Equipment

	1996		1995	
	Cost $	Net Book Value $	Cost $	Net Book Value $
Petroleum and Natural Gas Properties	**6,862,204**	**6,718,553**	1,619,137	1,619,137
Tax Benefits Renounced	**(2,716,208)**	**(2,716,208)**	(630,486)	(630,486)
Computer Equipment and Furniture	**51,953**	**46,842**	29,836	29,836
	4,197,949	**4,049,187**	1,018,487	1,018,487

As at December 31,1996 property and equipment includes unproved properties of $947,000 (1995- $989,000) which have been excluded from costs subject to depletion.

The Company capitalized all of its general and administrative costs while in the preproduction stage and, consistent with the full cost method of accounting, that portion of general and administrative costs relating to acquisition, exploration and development activities since July 1, 1996. Details are as follows:

	1996	1995
Total General and Administrative Expenditures	$ 563,499	$ 194,999
Less Capitalized as Part of Petroleum and		
Natural Gas Properties		
During Preproduction Stage	(285,155)	(194,999)
July 1 - December 31	(174,668)	–
General and Administrative Expense	103,676	–

4. Share Capital

Authorized

Unlimited number of Class A common shares, voting, with no par value.

Unlimited number of Class B common shares, voting, with no par value.

Issued and outstanding

	1996		1995	
	Number of Shares	Consideration $	Number of Shares	Consideration $
Class A Shares				
Balance, Beginning of Period	3,570,000	714,000	–	–
Initial Subscription	–	–	1,050,000	210,000
Pursuant to Initial Public Offering	–	–	2,520,000	504,000
Pursuant to Private Placement	220,500	496,125	–	–
Issue of Flow-Through Exchange Rights	–	699,160	–	–
Balance, End of Period	3,790,500	1,909,285	3,570,000	714,000
Class B Shares				
Balance, Beginning of Period	887,250	2,918,514	–	–
Pursuant to Initial Public Offering	736,750	2,947,000	887,250	3,549,000
Less: Tax Benefits Related to				
Renounced Expenditures	–	(2,085,722)	–	(630,486)
Balance, End of Period	1,624,000	3,779,792	887,250	2,918,514
Share Issue Costs,				
Net of Deferred Income Taxes		(448,211)		(418,375)
Reserved for Issue				
Class B Shares				
Balance, Beginning of Period	736,750	2,947,000	–	–
Pursuant to Initial Public Offering	(736,750)	(2,947,000)	736,750	2,947,000
Balance, End of Period	–	–	736,750	2,947,000
Share capital, end of period		5,240,866		6,161,139

Initial public offering

On August 16, 1995 the Company closed it initial public offering of 7,000 units. Each $1,000 unit consisted of 360 Class A common shares (the Class A shares), 232 Class B flow-through common shares (the Class B shares) and 180 Class A common share purchase warrants. The subscription price for each unit was applied as to $72 to purchase 360 Class A shares at $0.20 per share and as to $928 to purchase 232 Class B shares at $4.00 per share. Subscribers were given the option of paying for their units at closing or in two instalments with the final instalment due January 2, 1996. A total of 2,520,000 Class A shares and 887,250 of the Class B shares were issued on closing of the offering.

The Class A shares and 887,250 of the Class B shares were issued for cash; 736,750 Class B shares were reserved for issue pursuant to the instalment agreement. Subsequent to December 31, 1995, $2,947,000 of share subscriptions receivable were received.

Each Class A share purchase warrant entitles the holder to acquire one Class A share for $1.50 until June 30, 1997. At December 31, 1996, 1,260,000 (1995 - 1,260,000) Class A share purchase warrants were outstanding.

The Class B shares will be convertible into Class A shares at the Company's option at any time after June 30, 1998 and before June 30, 2000. The fraction of a Class A share obtained upon conversion of each Class B share will be equal to $4.00 divided by the greater of $1.00 or the current market price of the Class A shares at that time. Should the Company fail to exercise the conversion option by June 30, 2000, the Class B shares are convertible, at the option of the shareholder, at any time after July 1, 2000 and before August 31, 2000 into Class A shares. Any Class B shares not converted to Class A shares by August 31, 2000 are deemed to be converted at that time. Such conversion would result in a maximum of 6,496,000 Class A shares being issued.

In accordance with the terms of the initial public offering and pursuant to certain provisions of the Income Tax Act (Canada), the Company is required to renounce, for income tax purposes, to the holders of the Class B shares $6,496,000 of exploration and development expenditures effective as of December 31, 1996. As of December 31, 1996 the Company incurred renouncable exploration expenditures of $6,277,646 (1995 - $1,432,923). To recognize the foregone tax benefits to the Company, the carrying value of the property and equipment costs and the Class B shares have been reduced by $2,716,208 (1995 - $630,486).

Private placement

On December 16, 1996, 220,500 Class A flow-through shares were issued at $2.25 per share for total consideration of $496,125. In accordance with the terms of the private placement, the Company was required to renounce, for income tax purposes, to the holders of the Class A flow-through shares, $496,125 of exploration expenditures effective as of December 31, 1996. As of December 31, 1996, the Company renounced all of the exploration expenditures. The Company is required to make the related expenditures by December 31, 1997 and will recognize the foregone tax benefits as a reduction of the carrying value of the property and equipment costs and Class A shares when the expenditures are incurred. No expenditures related to this renunciation were incurred by December 31, 1996.

Flow-through exchange rights

On December 23, 1996 the Company issued 308,000 flow-through exchange rights at a price of $2.27 per flow-through right for total consideration of $699,160. Each flow-through right entitles the holder to exchange one flow-through right for one Class A share without any additional consideration. As of March 11,1997 none of the exchange rights have been exchanged. In accordance with the terms of the flow-through exchange rights agreement, the Company was required to renounce, for income tax purposes, to the holder of the exchange rights, $699,160 of exploration expenditures effective as of December 31, 1996. As of December 31, 1996 the Company renounced all of the

exploration expenditures. The Company is required to make the related expenditures by December 31, 1997 and will recognize the foregone tax benefits as a reduction of the carrying value of the property and equipment costs and Class A shares when the expenditures are incurred. No expenditures related to this renunciation were incurred by December 31, 1996.

Escrowed shares

At December 31, 1996 an aggregate of 633,600 of the Class A shares issued to the founders were held in escrow. Of the remaining Class A shares held in escrow, 158,400 will be released annually upon each of the second, third, fourth and fifth anniversary from July 20, 1995.

Stock option plan

The Company has established a stock option plan whereby up to 10% of the issued Class A common shares will be available for purchase by the directors, officers and employees of the Company.

	1996	1995
Options Outstanding, Beginning of Period	270,000	–
Granted	45,000	270,000
Exercised	–	–
Cancelled	–	–
Options Outstanding, End of Period	315,000	270,000

The stock options vest over a three year period from the date of grant and, if unexercised, will expire on the fifth anniversary from the date of grant. As at December 31, 1996 the Company had 315,000 stock options outstanding, exercisable at a price of $1.30 and expiring on the fifth anniversary from the date of grant.

On January 17, 1997, 82,000 additional stock options were granted to various directors, officers and employees of the Company at an exercise price of $2.05. Also subsequent to year end, 15,000 stock options were exercised at a price of $1.30 and 75,000 options were cancelled.

Share issue costs

For the year ended December 31, 1996 share issue costs of $800,378 (1995 - $747,099) are presented net of deferred income taxes of $352,167 (1995 - $328,724).

5. Deferred Income Tax Provision

The provision for deferred income taxes is different from the amount computed by applying the combined statutory Canadian Federal and Provincial tax rates to earnings before deferred income taxes. The reasons for these differences are as follows:

	1996
Corporate Income Tax Rate	44.62%
Computed Expected Provision for Income Taxes	$ 148,000
Increase (Decrease) in Taxes Resulting From:	
Non-Deductible Crown Charges	43,000
Alberta Royalty Tax Credit	(32,000)
Resource Allowance	(20,000)
Non-Deductible Depletion	63,000
Deferred Income Tax Provision	$ 202,000

The following deductions are available for future income tax purposes:

	1996	Annual Rate of Claim
Canadian Development Expense	$ 35,000	30%
Canadian Exploration Expense	4,000	100%
Canadian Oil and Gas Property Expense	27,000	10%
Undepreciated Capital Cost	$ 447,000	20 - 100%

6. Earnings and Funds From Operations Per Class A Share

1996	Basic	Fully Diluted
Earnings per Class A share	0.04	0.02
Funds from operations per Class A share	0.13	0.06
Weighted average number of Class A shares outstanding	3,579,062	8,392,653

Earnings and funds from operations per Class A share have been calculated based on the weighted average number of Class A shares outstanding over the year ended December 31, 1996.

Fully diluted earnings per Class A share and fully diluted funds from operations per Class A share have been calculated assuming that the Class B shares were converted into Class A shares at the beginning of 1996 using the December 31, 1996 closing price of $2.01.

Proceeds from the exercise of stock options and warrants are assumed to have been invested in short term deposits at an after tax yield of 1.5% per annum.

7. Commitment

The Company is committed to an operating lease for office premises. Future payments are as follows:

	$
1997	53,971
1998	58,879
1999	58,879
2000	58,879
2001	58,879
	289,487

Corporate Information

oard of Directors

evin McLachlan
resident

n Collar
ice-President, Exploration

hn Gareau
resident, Pentagon Energy Inc.

onald Quillian
dependent Businessman

fficers and Key Personnel

evin McLachlan
resident

n Collar
ice-President, Exploration

regory Turnbull
ecretary

arla Carr
rporate Administrator

arth Fordyce
anager, Land & Contracts

onsultant

ita Ciarla
ccounting Representative

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Calgary, Alberta

Auditors

Ernst & Young
Calgary, Alberta

Bankers

Alberta Treasury Branches
Calgary, Alberta

Registrar and Transfer Agent

Montreal Trust Company of Canada
Calgary, Alberta

Solicitors

Code Hunter Wittmann
Calgary, Alberta

Stock Exchange Listing

The Alberta Stock Exchange
Trading Symbols

Class A Shares:	KNN.A
Class B Shares:	KNN.B
Warrants:	KNN.WT.A

Produced by Canada Corporate Communications Inc.